

# State Notes

## TOPICS OF LEGISLATIVE INTEREST

May/June 2004



### Michigan's Recent Tobacco Tax Increase by Jay Wortley, Senior Economist

On June 24, 2004, the Legislature passed and the Governor signed into law increases in Michigan's taxes on cigarettes and other tobacco products. These increases are intended to help solve budget problems facing State government in fiscal year (FY) 2003-04 and FY 2004-05. This article provides a brief summary of the major components of these recent tax increases.

**Table 1**

Cigarette Tax Rates by State (as of July 1, 2004)					
State	Cents/Pack	Rank	State	Cents/Pack	Rank
Alabama	42.5	37	Montana	70	23
Alaska	100	13	Nebraska	64	25
Arizona	118	11	Nevada	80	20
Arkansas	59	27	New Hampshire	52	34
California	87	19	New Jersey	205	1
Colorado	20	44	New Mexico	91	18
Connecticut	151	4	New York	150	6
Delaware	55	30	North Carolina	5	50
District of Columbia	100	13	North Dakota	44	36
Florida	33.9	42	Ohio	55	30
Georgia	37	39	Oklahoma	23	43
Hawaii	140	8	Oregon	118	11
Idaho	57	28	Pennsylvania	135	9
Illinois	98	17	Rhode Island	171	3
Indiana	55.5	29	South Carolina	7	49
Iowa	36	40	South Dakota	53	33
Kansas	79	21	Tennessee	20	44
Kentucky	3	51	Texas	41	38
Louisiana	36	40	Utah	69.5	24
Maine	100	13	Vermont	119	10
Maryland	100	13	Virginia <sup>1)</sup>	20	44
Massachusetts	151	4	Washington	142.5	7
<b>Michigan</b>	<b>200</b>	<b>2</b>	West Virginia	55	30
Minnesota	48	35	Wisconsin	77	22
Mississippi	18	47	Wyoming	60	26
Missouri	17	48	U.S. Average	75.9	---

<sup>1)</sup> Virginia's tax rate is scheduled to increase from 2.5 cents to 20 cents effective 8-1-04.

**Source:** The Federation of Tax Administrators, National Center for Tobacco-Free Kids, and Michigan Senate Fiscal Agency.

### Cigarette Tax

The cigarette tax was increased \$0.75 per pack from \$1.25 to \$2.00 per pack, effective July 1, 2004. As shown in Table 1, this pushed up Michigan's cigarette tax rate to the second highest among the states, and made it higher than the cigarette tax in any of Michigan's neighboring



states by more than \$1 per pack. Assuming that all of this tax increase is reflected in the retail price of cigarettes, the average price for a pack of cigarettes in Michigan will jump up 16% to over \$5 per pack. In response to this price increase, it is estimated that cigarette sales in Michigan will decline in FY 2004-05 to 573 million packs from the 674 million packs that were expected to be sold under the old tax rates. The revenue that will be lost due to the decline in the number of packs of cigarettes that will be purchased in Michigan will be more than offset by the 60% increase in the tax rate. As a result, it is estimated that the \$0.75 per pack increase in the cigarette tax rate will generate a net increase in revenue equal to \$64 million in FY 2003-04, \$302 million in FY 2004-05, and \$298 million in FY 2005-06, as shown in Table 2.

**Table 2**

<b>Tobacco Tax Increases Estimated Net New Revenue (dollars in millions)</b>				
<b>Fiscal Year</b>	<b>Cigarette Tax</b>	<b>Other Tobacco Products Tax</b>	<b>Inventory Tax</b>	<b>Total Tobacco Taxes</b>
FY 2003-04	\$63.8	\$3.3	\$30.0	\$97.1
FY 2004-05	302.0	11.6	0.0	313.6
FY 2005-06	297.6	11.5	0.0	309.1

**Source:** Estimates adopted by the Senate Fiscal Agency, House Fiscal Agency, & Treasury Department.

### **Other Tobacco Products Tax**

Michigan also taxes other tobacco products, such as chewing tobacco and cigars. The tax on these other tobacco products is based on their wholesale price. The newly enacted law raises the tax rate 12 percentage points from 20% of the wholesale price to 32%, effective July 1, 2004. It is estimated that under the old 20% tax rate, this tax would have generated \$21 million annually. The new tax rate will increase the other tobacco products tax revenue by an estimated \$3.3 million in FY 2003-04, \$11.6 million in FY 2004-05, and \$11.5 million in FY 2005-06, as shown in Table 2.

### **Inventory Tax**

The cigarette and other tobacco products taxes are collected by tobacco wholesalers at the time they sell tobacco products to their customers, which primarily include retailers. As a result, beginning July 1, 2004, all tobacco products sold by wholesalers will be taxed at the new higher rates; however, the tobacco products held by retailers on July 1, 2004, were taxed at the old rate. In order to ensure that all tobacco products sold by retailers after June 30, 2004, are taxed at the new tax rates, a special tax on tobacco inventories also is needed. Therefore, products purchased by retailers before July 1, and still in their possession on July 1, will be assessed a special inventory tax. This tax equals the enacted tax rate increases (\$0.75 per pack of cigarettes and 12% of the wholesale price of other tobacco products). Retailers will be required to file a report detailing the inventory of tobacco products they held on July 1, 2004, and must transmit this report, along with the tax payment, to the Department of Treasury by August 1, 2004. It is estimated that this inventory tax will generate \$30 million in FY 2003-04.



## **Tax Collection Allowance**

Tobacco wholesalers collect the tobacco taxes and then remit the tax receipts to the Treasury Department. In order to cover the costs they incur when collecting the State's tobacco products taxes, wholesalers are allowed to keep 1.5% of the tax they collect. It is estimated that wholesalers would have realized about \$13.1 million in collection fees in FY 2004-05 if the tax rates had not changed. With the increases in the tax rates, since wholesalers now will be collecting more tobacco tax revenue, the amount they will receive for collecting the tax also will increase. It is estimated that the new higher tax rates will boost the wholesalers' collection allowance by \$4.8 million in FY 2004-05 to a total of \$17.9 million.

## **Earmarking of Tobacco Tax Revenue**

The distribution of tobacco tax revenue is fairly complicated. Not only is the revenue distributed to six different budget areas, but the revenue derived from four pieces of the cigarette tax rate (\$0.75, \$0.30, \$0.20, and the new \$0.75) is distributed differently. To help simplify the discussion of the tobacco tax distribution, Table 3 summarizes the distribution of tobacco tax revenue, in aggregate, under both the old and the new tax rates. Before the recent tax increases were enacted, about 55% of tobacco tax revenue was earmarked to the School Aid Fund and about 32% went to the General Fund. The remaining revenue went to the Healthy Michigan Fund (6.0%), Health and Safety Fund (3.1%), Medicaid Benefits Trust Fund (2.9%), and Wayne County (0.7%). The distribution among these funds is changing under the new tax rates in three major ways:

- 1) 100% of the revenue generated from the increases in the tax rates (\$0.75 per pack of cigarettes and 12% of the wholesale price of other tobacco products) will go into the Medicaid Benefits Trust Fund beginning in the last quarter of FY 2003-04 through the end of FY 2004-05. In FY 2005-06, 75% of this revenue will go into the Medicaid Benefits Trust Fund and 25% will go into the General Fund.
- 2) As part of the tobacco tax increase that went into effect in August 2002, a portion of the revenue that otherwise would have gone to the General Fund (about \$154 million in FY 2004-05) was scheduled instead to go into the Budget Stabilization Fund (BSF) beginning in FY 2004-05 through FY 2006-07. Under the new law, this revenue is moved from the BSF to the Medicaid Benefits Trust Fund.
- 3) The percentage distributions contained in the law for the old \$1.25 cigarette tax rate in combination with the reduction in the revenue that will be generated by the old cigarette tax rate (\$1.25 per pack) due to the anticipated decline in the volume of tobacco sales in Michigan, create some funding shifts among the General Fund and some of the other funds that receive tobacco tax revenue.

As shown in Table 3, the major change in how tobacco tax revenue is distributed under the new tax rates compared with the old tax rates is that much more money is dedicated to the Medicaid Benefits Trust Fund. In FY 2003-04, while net new tobacco tax revenue totals an estimated \$97 million, the Medicaid Benefits Trust Fund receives an additional \$132 million and the General Fund loses \$35 million, compared with the distribution under the old tax rates. In FY 2004-05,

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the major distributional changes increase Medicaid Benefits Trust Fund revenue by \$480 million, while the \$154 million originally earmarked to the Budget Stabilization Fund is eliminated. In FY 2005-06, the Medicaid Benefits Trust Fund and the General Fund will split the revenue generated from the increases in the tax rates, 75% and 25%, respectively, and the share of the revenue from the old tax rate earmarked to the BSF is eliminated. As a result, in FY 2005-06, tobacco tax revenue going to the Medicaid Benefits Trust Fund will increase \$360 million, General Fund revenue will increase \$105 million, and no tobacco tax revenue will be earmarked to the BSF.

**Table 3**  
**Enacted Tobacco Tax Increase**  
**Estimated Revenue Increase and Distribution**  
**FY 2003-04, FY 2004-05, AND FY 2005-06**  
**(dollars in millions)**

	<b>Previous Tax Rates</b>	<b>New Tax Rates</b>	<b>Net New Tobacco Tax Revenue</b>
<b>FY 2003-04</b>			
General Fund/General Purpose	\$286.2	\$251.7	(\$34.5)
School Aid Fund	479.6	480.5	0.9
Health & Safety	27.2	27.4	0.2
Healthy Michigan	52.6	50.7	(1.9)
Wayne County	6.2	6.2	0.0
Medicaid Trust	25.1	157.4	132.3
Budget Stabilization Fund	0.0	0.0	0.0
<b>Total</b>	<b>\$876.8</b>	<b>\$973.9</b>	<b>\$97.1</b>
<b>FY 2004-05</b>			
General Fund/General Purpose	\$128.0	\$118.9	(\$9.1)
School Aid Fund	472.7	476.5	3.8
Health & Safety	26.8	27.9	1.1
Healthy Michigan	51.8	42.9	(8.9)
Wayne County	6.1	6.4	0.3
Medicaid Trust	24.7	505.0	480.3
Budget Stabilization Fund	154.0	0.0	(154.0)
<b>Total</b>	<b>\$864.1</b>	<b>\$1,177.6</b>	<b>\$313.5</b>
<b>FY 2005-06</b>			
General Fund/General Purpose	\$126.1	\$231.1	\$105.0
School Aid Fund	465.8	469.4	3.6
Health & Safety	26.4	27.5	1.1
Healthy Michigan	51.1	42.3	(8.8)
Wayne County	6.0	6.3	0.3
Medicaid Trust	24.3	384.0	359.7
Budget Stabilization Fund	151.8	0.0	(151.8)
<b>Total</b>	<b>\$851.5</b>	<b>\$1,160.6</b>	<b>\$309.1</b>

**Source:** Estimates adopted by the Senate Fiscal Agency, House Fiscal Agency, & Treasury Department.